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BY THE COMPTROLLER GENERAL

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Report To The Congress

OF THE UNITED STATES

ORIGINAL

Updating Interest Rates Charged On Outstanding Civil Service Retirement Contributions Would Save Millions

Federal employees covered by the civil service retirement system are required to contribute toward meeting the system's costs. However, many retiring employees owe the retirement fund for periods of prior civilian service for which contributions were not made. GAO estimates that if the interest charged on prior service contributions had been 5 percent rather than 3 percent over the past 20 years, the fund would have realized a long-term savings of $79.6 million for fiscal year 1980 retirees alone. Significant savings could be realized each year if the Congress amends the system's provisions on interest charges as GAO is recommending.

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COMPTROLLER GENERAL OF THE UNITED STATES
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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses an outdated provision of the civil service retirement system regarding the rate of interest charged employees who owe contributions to the retirement fund. We undertook this review to determine whether this provision should be changed to reduce the cost of the civil service retirement system.

We are sending copies of this report to the Director, Office of Management and Budget, and to the Director, Office of Personnel Management.

Charles A. Bowsher

Comptroller General
of the United States

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COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

UPDATING INTEREST RATES CHARGED ON OUTSTANDING CIVIL SERVICE RETIREMENT CONTRIBUTIONS WOULD SAVE MILLIONS

D I G E S T

Although Federal employees covered by the civil service retirement system are required to contribute toward meeting the system's costs, many retiring employees owe the retirement fund for periods of prior civilian service for which contributions were refunded or were made. The General Accounting Office (GAO) reviewed (1) the interest rates charged on outstanding contributions and the need to update these rates since they had not been changed in over 30 years and (2) the application process used to make contributions for prior service.

The rate of interest charged on payments for periods of prior service is outdated. Since 1948, the interest rate has been only 3 percent, while for the past 20 years the retirement fund's return on its investments has averaged 5 percent. Recent earnings have been considerably higher. GAO estimates that if the interest charged on prior service contributions had been 5 percent rather than 3 percent over those 20 years, the fund would have realized a long-term savings of $79.6 million for fiscal year 1980 retirees alone.

GAO's review was limited to 1980 retirees, but significant savings can be realized each year in the future if the provisions on interest charges are amended. GAO estimates savings of about $12 million over the next 4 years.

Since April 1980, the Office of Personnel Management (OPM) has not processed employees' applications to make prior service contributions before retirement because the staff responsible for this function was reassigned to higher priority work. This action is resulting in lost investment income for the fund.

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Furthermore, contrary to a specific statutory prohibition, OPM is giving retirees credit for periods of prior service before their refunds are repaid. This practice, in effect, results in retirees receiving interest free loans with which they can pay their refunds.

RECOMMENDATION TO THE CONGRESS

GAO recommends that the Congress amend subsection 8334(e) of title 5 of the United States Code to provide that the annual rate of interest charged on prior service contributions each year be made equal to the average rate of return earned by the retirement fund's investments during the preceding year.

RECOMMENDATIONS TO THE DIRECTOR, OPM

GAO recommends that the Director, OPM, process all applications to make prior service contributions and terminate the practice of allowing credit for redeposit service before refunds are repaid.

AGENCY COMMENTS

OPM agreed with GAO's recommended change to the law and said it had recently submitted to the Congress a legislative proposal to make the change. OPM also agreed that it should process all applications to make prior service contributions and stop the practice of granting credit for redeposit service before refunds are repaid.

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ABBREVIATIONS

GAO	General Accounting Office
OPM	Office of Personnel Management

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CHAPTER 1

INTRODUCTION

The civil service retirement system was established in 1920 (Public Law 66-215) and is administered by the Office of Personnel Management (OPM). Currently, 2.7 million active Federal civilian employees are enrolled in the system. During fiscal year 1981, the system paid approximately $17.3 billion in benefits to 1.8 million retirees and survivor beneficiaries.

Since its establishment, the retirement system has required covered employees to share in the system's costs by contributing a percentage of their salary to the retirement fund. The system has included, however, provisions for granting some employees credit for periods of civilian service during which they have made no retirement contributions--noncontributory service--and for periods of service for which they have received a refund of their contributions--redeposit service. 1/ Over two-thirds of approximately 385,000 employees who retired in fiscal years 1977 through 1980 and whose retirement claims were settled by May 21, 1981, had either or both of these types of service. As required by law, interest is charged on outstanding contributions for any prior service. (See app. I.)

NONCONTRIBUTORY SERVICE

Noncontributory service is employment which is excluded by law or regulation from coverage under the retirement system. Examples of employees who do not contribute to the retirement fund during their employment are (1) temporary letter carriers or clerks for the Postal Service, (2) laborers who work as needed on military bases, (3) congressional employees who decline to participate in the civil service system, and (4) reemployed civil service retirees. Noncontributory service can also be service which is currently, but was not formerly, covered by the retirement system. An example of this type of service is National Guard technician service performed before 1969.

The law currently provides that employees who have had noncontributory service and who subsequently became employed in a position covered by the retirement system may receive full credit

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1/Employees may also receive credit for prior military service for which they are not required to contribute to the retirement fund. The Government makes a direct annual appropriation to the fund to cover benefits attributable to military service. This report is not concerned with this type of noncontributory service.

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for the noncontributory service in the computation of their annuities. However, if they do not make a deposit to cover the period of service, or elect to have such service eliminated entirely for annuity computation purposes, their annuities will be reduced by 10 percent of the amount of the unpaid deposit. (See 5 U.S.C. 8339(i).) The amount of a deposit for noncontributory service consists of the retirement deductions that would have been withheld from an employee's pay during the time the service was performed if the employee had been covered by the system plus interest from the midpoint of such period of service to the date of deposit or the date of retirement, whichever is earlier.

REDEPOSIT SERVICE

Redeposit service refers to earlier service by currently covered employees for which their contributions have been refunded. Receipt of a refund forfeits an individual's right to an annuity. To reestablish this right, an individual must be reemployed in a covered position and redeposit withdrawn contributions (plus interest from the date of the refund to the date of redeposit or the beginning date of annuity, whichever is earlier) before credit can be allowed for the service in the computation of an annuity. (See 5 U.S.C. 8334(d).) Such service is credited, however, in determining an employee's eligibility for retirement regardless of whether or not a redeposit is made.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our review were to evaluate (1) the rate of interest charged on both deposits and redeposits, which has remained unchanged since 1948 and, in recent years, has been considerably lower than the average rate of return earned on the retirement fund's investments and (2) the application process used to make contributions for prior service.

Our review was made during the period of April through November 1981, in accordance with our Office's current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions." We researched available legislative history relating to the interest rates charged for noncontributory and redeposit service. We reviewed the current regulations and procedures on deposits and redeposits, as prescribed by OPM's Federal Personnel Manual.

We interviewed OPM officials concerning their policies and procedures for administering the retirement system's deposit and redeposit provisions. We also discussed these policies with officials in OPM's Office of Internal Evaluation which was reviewing certain procedures relating to redeposits.

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To determine the incidence of noncontributory and redeposit service among recent retirees, we obtained data from OPM 1/ on employees who retired during fiscal years 1977 through 1980. The data showed how many of these employees had either or both types of service. From the data, we selected a statistical sample of the 1980 retirees. The sample provided the basis for our evaluation. (Details of the sample are presented in app. II.) Although we did not test the accuracy of OPM's summary data on employees who retired in fiscal years 1977 through 1980, we found no discrepancies in the fiscal year 1980 retirement files we reviewed.

1/Data were obtained from OPM's automated master record of annuity files.

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CHAPTER 2

LOW INTEREST CHARGES AND OPM ACTION CAUSE LOSS OF INVESTMENT INCOME

The rate of interest charged on prior service contributions has not been sufficient to compensate the retirement fund for investment income it lost during the period of time the contributions were outstanding. For the past 20 years, the retirement fund's return on its investments has averaged 5 percent while the interest charged on prior service contributions has been only 3 percent. We estimate that if 5 percent interest had been charged on amounts owed by fiscal year 1980 retirees, the retirement fund could have realized net long-term savings of about $79 million.

The retirement fund is also losing investment income because OPM, in 1980, stopped processing certain applications to make deposits and redeposits. Also, we found that OPM's practice of giving credit for redeposit service before a refund is repaid is contrary to statutory requirement.

BACKGROUND OF INTEREST RATES

The retirement system has always required that an interest charge be included in determining the amount owed for prior service. The purpose of the interest charge is to compensate the retirement fund for investment income lost during the period of time the deposit or redeposit was outstanding.

Until 1948, the rate of interest charged on deposits and redeposits was 4 percent and equaled the rate of interest earned on the retirement fund's investments. The interest charge was reduced to 3 percent in 1948, but the reason for the reduction is not apparent from the legislative history. We did note, however, that 6 years later, in 1954, the rate of return on the retirement fund's investments was reduced from 4 to 3 percent at the discretion of the Secretary of the Treasury.

In 1956, the Congress prescribed a specific method for establishing the fund's investment income, and for most years since then the average rate of interest earned by the fund has been greater than the 3 percent rate of interest charged on deposits and redeposits. This 3 percent rate of interest is still in effect. Another change made by the Congress in 1956 was to require that interest on deposits and redeposits be charged during the entire period they remained unpaid. Prior to this change, no interest accrued during a period of separation.

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CONTRIBUTIONS OWED FOR NONCONTRIBUTORY SERVICE

About 66,700 of the 107,000 employees who retired during fiscal year 1980 had had at least one period of noncontributory service during their Government careers. About 59,000 of these retirees did not make contributions to the retirement fund for that service and, therefore, received reduced annuities. In order to estimate the average length of service and the average deposit amount involved in these cases, we randomly selected and reviewed the retirement files of 96 of the 66,700 retirees. The sample size allowed us to make certain projections at a 95 percent level of confidence. (See app. II.) The results of our sample follow:

--The average deposit owed was $949, including interest. 1/

--The retirees had been continuously employed under the retirement system for an average of 20 years immediately before retirement.

CONTRIBUTIONS OWED FOR REDEPOSIT SERVICE

About 23,800 fiscal year 1980 retirees had redeposit service; 93 percent of them (22,082) made a redeposit for the service. In order to estimate the average length of service and the average amount of a redeposit involved in these cases, we randomly selected and reviewed the files of 97 of the 23,800 retirees. This sample size allowed us to make projections to the entire universe at a 95 percent level of confidence. (See app. II.) Our sample showed that the average redeposit paid was $1,265, including interest. 2/

LOW INTEREST CHARGES RESULT IN LOST INCOME AND INCREASED OUTLAYS

During the 20-year period ending September 1980, the retirement fund's return on its investments averaged 5 percent; recent earnings have been significantly higher. In fiscal year 1980, the return on investments averaged 8.5 percent.

1/In projecting our sample findings to the universe of 1980 retirees we estimated that, at the 95 percent level of confidence, the average deposit would range from $763 to $1,135.

2/In projecting our sample findings to the entire universe, we estimate that, at the 95 percent confidence level, the average redeposit paid by fiscal year 1980 retirees ranged from $950 to $1,588.

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We estimated that if the interest charged had been 5 percent rather than 3 percent, the average amount of deposit and redeposit paid by fiscal year 1980 retirees would have been increased by $320 and $546, respectively. In the case of deposits which were owed, but not paid, the average increase for each retiree would have been $595. 1/ Consequently, the average amount of annuity reductions for unpaid deposits for noncontributory service would have been $59 greater (10% of $595).

The following table shows what the estimated first-year and long-term effect on the retirement fund would have been had fiscal year 1980 retirees been charged 5 percent interest.

	Estimated effect on retirement fund	
	First-year	Long-term
	(millions)	
Additional interest that would have been paid on 22,000 redeposits	$12.0	$12.0
Additional interest that would have been paid on 7,700 deposits	2.5	2.5
Present value of initial and future increases in annuity reductions due to 59,000 unpaid deposits	3.5	65.1
Net savings	$18.0	$79.6

The estimated $65.1 million for annuity reductions shown above reflects the fact that the value of the amount by which an annuity is reduced at the time of retirement will increase with each future annuity cost-of-living adjustment. In calculating the present value of the future annuity reductions, we used a real discount rate of 1 percent because, in a recent report on the financial status of the retirement system, OPM assumed that over the long run the rate of return on the retirement fund's investments would be 1 percentage point above the rate of inflation.

1/In projecting our sample findings to the entire universe, we estimate that, at the 95 percent confidence level, the increase in the average deposit paid by fiscal year 1980 retirees would range from $117 to $406, and the increase in the average redeposit paid would range from $421 to $671. The increase in the average unpaid deposit would range from $472 to $718.

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OPM has projected that, during fiscal years 1982 through 1986, the retirement fund's investments will earn about 9 percent interest each year. If the rate of interest charged each year on outstanding deposits and redeposits were equal to the average rate of return earned on the fund's investments during the preceeding year, we estimate that the fund would receive a total of $11.8 million more in interest income over the 4-year period. This estimate was based on OPM's projections and the fact that average annual total deposits and redeposits made in fiscal years 1977 through 1980 were $38 million.

INCOME LOST BECAUSE OPM SUSPENDED PROCESSING OF PRERETIREMENT DEPOSIT AND REDEPOSIT APPLICATIONS

The retirement fund is losing interest income because OPM suspended the processing of certain applications to make deposits and redeposits. Under existing OPM regulations, a deposit or redeposit may be made by any employee serving in a position covered by the retirement system or by a former employee who has a vested right to a future annuity. A deposit or redeposit may also be made by the surviving spouse of a deceased employee. Under no circumstance may a deposit or redeposit be made after final adjudication of a claim for retirement or survivor benefits. Individuals wishing to make a contribution for prior service must submit an application to OPM.

In April 1980, OPM stopped processing employees' applications to make prior service contributions and reassigned the staff to what it considered higher priority work. Although OPM instructed agencies to notify their employees about this action, applications continued to arrive. By November 1981, there was a backlog of 10,000 applications, including some applications which had been on hand when the operation was suspended. OPM reported that only special cases were being processed, usually those involving congressional interest. As a result, employees could not make prior service contributions until retirement, and the fund lost potential interest income.

According to OPM, many of the employees who filed applications did not intend to make payments and were only interested in learning how much they owed and/or how much service was involved. In sampling the 6,500 accounts set up in the 3-month period prior to April 1980, OPM found that as of June 1980 no payments had been made on more than 60 percent of the accounts in the sample.

In justifying its decision to continue the suspension, OPM points to (1) the large number of accounts on which no payments are received, (2) the low interest rate charged on amounts outstanding, and (3) the fact that employees always have an opportunity to pay at the time of retirement.

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REDEPOSIT SERVICE IS CREDITED BEFORE A REDEPOSIT IS MADE: CONTRARY TO STATUTORY REQUIREMENT

OPM presently allows credit for redeposit service in computing annuity payments before the redeposit is made even though subsection 8334(d), title 5, United States Code, specifically states that no credit for redeposit service will be granted until a redeposit is made. In adjudicating retirement claims involving redeposit service, OPM provides employees the following three options:

--Make no redeposit and, in computing the amount of an annuity, eliminate credit for the service involved.

--Make a lump-sum redeposit and receive credit for the service.

--Receive immediate credit for all service by authorizing OPM to withhold future annuity payments until an amount equal to the redeposit owed has been collected.

In our sample of fiscal year 1980 retirement cases involving redeposit service, we found that about 40 percent of the retirees had elected the option of having redeposits deducted from their annuities. This option is not only contrary to statutory requirement, but, in effect, results in the retirement fund giving retirees interest-free loans with which they can repay their refunds.

CONCLUSIONS

The current 3 percent rate of interest charged on unpaid deposits and redeposits is outdated and does not adequately compensate the retirement fund for interest income it loses by not having the prior service contributions to invest. Increasing the interest rate to reflect the rate of return earned on the retirement fund's investments would result in significant immediate and long-term savings to the fund.

We do not agree that OPM was justified in suspending the processing of applications. Although employees have an opportunity to pay at the time of retirement, the fact remains that the retirement fund is losing investment income because OPM's suspension is causing payments to be deferred. The longer the contribution remains unpaid, the more investment income the fund loses. Furthermore, employees who would like to make prior service contributions before retirement are incurring additional interest charges because of the suspension.

To discourage applications from individuals who are not really interested in making contributions, OPM could establish

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a requirement that an initial payment, in a specified amount, accompany all future applications. The payment would be applied to reduce the amount of any deposit or redeposit the applicant owes. If, for some reason, an application is rejected or the initial payment exceeds the amount owed, a refund could be made.

Finally, it is clear that the practice of allowing retirees to make redeposits by offsetting their full annuities is contrary to the specific statutory requirement that a redeposit must first be made before any credit can be given for redeposit service.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress amend title 5 of the United States Code to provide that the annual rate of interest charged on prior service contributions each year be made equal to the average rate of return earned by the retirement fund's investments during the preceding year.

Specifically, we recommend that subsection 8334(e) of title 5 be amended by striking out the second sentence and inserting:

> "The interest is computed at the rate of 4 percent a year to December 31, 1947, and 3 percent a year beginning January 1, 1948, through December 31, 1982, compounded annually. Thereafter, the rate of interest for each calendar year shall be established by December 31 of the preceding year by the Office of Personnel Management, to equal the average yield for the preceding fiscal year on all issues in which monies in the Fund were invested."

RECOMMENDATIONS TO THE DIRECTOR, OPM

We recommend that the Director, OPM

--process all applications to make prior service contributions, and

--terminate the practice of allowing credit for redeposit service before a redeposit has been made.

AGENCY COMMENTS

OPM agreed with our recommendation on changing the law regarding the rate of interest charged on prior service contributions and said it had submitted a legislative proposal to the Congress on April 28, 1982, to make the needed change. OPM also agreed to begin processing, to the extent current resources permitted, all applications to make deposits and redeposits and to stop allowing credit for redeposit service before refunds are repaid.

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APPENDIX I

INCIDENCE OF DEPOSITS AND REDEPOSITS IN RETIREMENT CLAIMS, FISCAL YEARS 1977 THROUGH 1980 (note a)

	FY 1980	%	FY 1977 thru 1980	%
Claims involving deposits and/or redeposits b/	73,133	68	265,389	69
Claims involving neither	34,194	32	119,991	31
Total	107,327	100	385,380	100
Claims involving paid deposits	7,742	12	28,109	12
Claims involving unpaid deposits	58,968	88	212,598	88
Total	66,710	100	240,707	100
Claims involving paid redeposits	22,083	93	79,532	89
Claims involving unpaid redeposits	1,752	7	10,005	11
Total	23,835	100	89,537	100

a/The data in the table are based on claims adjudicated by OPM as of May 21, 1981.

b/Some retirement claims involved both deposits and redeposits.

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APPENDIX II

METHODOLOGY FOR SELECTING STATISTICAL SAMPLES OF FISCAL YEAR 1980 RETIREES WITH NONCONTRIBUTORY AND REDEPOSIT SERVICE

During our review we used data collected from two separate samples of retirement files. The samples were selected from the retirement files of 107,327 employees who retired in fiscal year 1980 and whose claims had been adjudicated by OPM as of May 21, 1981. One sample was drawn from a universe of retirement claims involving noncontributory service, and the other sample was taken from a universe of claims involving redeposit service. The samples were drawn on the basis of randomly selected sets of social security account digits.

The files included in the samples were then requested from OPM. Whenever a requested file was unavailable, we selected a replacement from the files remaining in the initial, larger samples in order to maintain the predetermined sample size. We assumed that, with respect to the variables we were interested in analyzing, the replacement files did not differ from the unavailable files. Following is a summary of information regarding our two samples.

	Sample of retirees with noncontributory service	Sample of retirees with redeposit service
Universe size	66,710	23,835
Sample size	96	97

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